DEPARTMENT OF STATE REVENUE

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Letter of Findings: 06-0365
Financial Institutions Tax
For the Years 2003, 2004, 2005

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ISSUE

I. Financial Institutions Tax – Imposition.

Authority: IC § 6-5.5-2-1; IC § 6-5.5-3-1; IC § 6-5.5-1-12; IC § 6-5.5-1-13; IC § 6-5.5-1-17; IC § 6-5.5-3-8; IC § 6-5.5-4-8; IC § 6-8.1-5-1; 45 IAC 17-2-1; 45 IAC 17-2-4; 45 IAC 17-2-6; 45 IAC 17-2-8; 45 IAC 17-2-9; 15 U.S.C. § 381; *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayers protest the assessment of this tax arguing that they do not have nexus with Indiana.

II. Tax Administration – Ten Percent Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayers protest the proposed assessment of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayers (Bank and Credit) are affiliated wholly-owned subsidiaries of a department store retailer (Parent), that conducts business in multiple states including Indiana. (Taxpayers will also be referred to separately as Bank or Credit as appropriate). Credit's primary business is to finance retail charge card receivables generated under revolving charge accounts through sales of merchandise at Parent's stores, one of which is in Indiana. The receivables originate through the use of Parent's retail charge cards issued by Bank. Bank is a federal savings association. Parent, Bank, and Credit are located in different states, all outside Indiana.

Under an operating agreement dated August 30, 1991, as amended on March 1, 2000, and October 1, 2000, Credit purchases receivables from Bank for a price equal to the amount of the receivables originated. Bank performs the servicing functions for the receivables. Credit pays an annual servicing fee of two-percent to Bank based on the average balance of the receivables. Credit also pays a monthly marketing fee to Bank for its marketing efforts to increase retail charge card receivable balances upon which it earns finance charge income. A February 1, 2002, amendment to the operating agreement specifically stipulates that Bank will provide Credit with marketing services to promote the retail card, which is the private label card issued by Bank.

Taxpayers file a consolidated Federal Income Tax return under "[Bank] & Affiliate." Taxpayers are non-filers for Indiana Financial Institutions Tax. The Department conducted an audit of Taxpayers and determined they are subject to the Indiana Financial Institutions Tax (FIT). The Department calculated the FIT liability for nonresident Bank and Credit filing a combined return. Taxpayers protested the Department's determination and the associated penalty. An administrative hearing was held during which Taxpayers presented the basis for their protest. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Financial Institutions Tax – Imposition.

DISCUSSION

The Department concluded that Taxpayers are subject to the Indiana Financial Institutions Tax pursuant to IC § 6-5.5-2-1 and 45 IAC 17-2-1 because they were transacting the business of a financial institution as defined in IC § 6-5.5-3-1(4) and (6).

The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made. IC § 6-8.1-5-1(b), (c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Within Indiana, "There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana." IC § 6-5.5-2-1(a).

The FIT is imposed on both "nonresident taxpayers" and "resident taxpayers" transacting business within this state. IC § 6-5.5-1-12,13. The statute defines a "nonresident taxpayer" as "a taxpayer that (1) is transacting business within Indiana as provided in IC § 6-5.5-3; and (2) has its commercial domicile outside Indiana." IC § 6-5.5-1-12.

45 IAC 17-2-1 elaborates that the FIT "is intended to tax both traditional financial institutions that are transacting business within Indiana, as well as other types of businesses that are deemed to be transacting the business of a financial institution in Indiana."

For purposes of the FIT, a corporation that is transacting the business of a financial institution, includes a regulated financial corporation, IC § 6-5.5-1-17(a)(2), any other corporation that is carrying on the business of a financial institution, IC § 6-5.5-1-17(a)(4), and specifically includes "[o]perating a credit card, debit card, charge card, or similar business." IC § 6-5.5-1-17(d)(2)(C).

45 IAC 17-2-4(b), in relevant part, elaborates on "other corporations" subject to FIT:

(b) The corporation is deemed to be conducting the business of a financial institution and therefore subject to the FIT if eighty percent (80[percent]) or more of the corporation's gross income during the taxable year is derived from the following activities:

(1) Extending credit. (Refer to subsection (e) below.)

...

(3) Credit card operations.

(c) As used in this section, "gross income" includes the income derived from activities which are performed by corporations primarily (as defined by the eighty percent (80[percent]) test) engaged in the business of extending credit. Gross income includes income from the following:

(1) Interest.

(2) Fees.

(3) Penalties.

(4) A market discount or other type of discount.

...

(e) For purposes of satisfying the eighty percent (80[percent]) test, corporations which are in the business of a financial institution must be conducting the activities of extending credit,..., or credit card operations, as follows:

(1) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include secured or unsecured consumer loans;...; credit card loans;...; loans arising in factoring; and any other transactions with a comparable economic effect.

...

(3) Operating a credit card, debit card, charge card, or similar business. If eighty percent (80[percent]) of a corporation's total gross income is derived from:

(A) extending credit;

(B) leasing; or

(C) credit card operations;

the corporation is subject to the FIT.

Therefore, based on the above facts and law, Bank and Credit are clearly financial institutions.

The next and determinative question, then, is whether Taxpayers are conducting the business of financial institutions in Indiana.

Pursuant to IC § 6-5.5-3-1, a financial institution is transacting business within Indiana if it:

(1) maintains an office in Indiana;

(2) has an employee, representative, or independent contractor conducting business in Indiana;

(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;

(4) *regularly solicits business from potential customers in Indiana*;

(5) regularly performs services outside Indiana that are consumed within Indiana;

(6) *regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana*;

(7) owns or leases tangible personal or real property located in Indiana; or

(8) regularly solicits and receives deposits from customers in Indiana.

(*Emphasis added*).

For purposes of FIT, 45 IAC 17-2-6(b) elaborates, in relevant part, on what "regularly" transacting business within Indiana means:

For purposes of this article, "regularly", when applied to any business activity, depends on the number of transactions, and with respect to any transaction, its size and complexity and whether it involves one (1) act or a series of activities to be performed over a substantial time period, and the extent to which any transaction or transactions involve the protection by the laws, government, or public institutions of the state of Indiana. The following are examples:

(1) A corporation which operates a credit card or charge card business and executes a contract with cardholders enforceable in Indiana which is evidenced by one (1) or more of the following: billed to cardholders in Indiana, providing interest on any amount due until paid, providing a card which operates as a form of money for purchasing material and services in Indiana, or establishes contracts with the Indiana vendors.

Furthermore, 45 IAC 17-2-8 defines "soliciting business":

A taxpayer is not required to be physically present within Indiana to be soliciting business. Soliciting business includes, but is not limited to, the following:

(1) The distribution, by mail or otherwise, of catalogs, periodicals, advertising flyers, or other written solicitations of business to potential customers in Indiana, without regard to the state from where the

distribution originated or where the materials were prepared.

(2) Display of advertisements on billboards or other outdoor advertising in this state.

(3) Advertisements in newspapers published in this state.

(4) Advertisements in trade journals or other periodicals, the circulation of which is primarily within this state.

(5) Advertisements in an Indiana edition of a national or regional publication or a limited regional edition of which this state is included as part of a broader regional or national publication, and which are not placed in other geographically defined editions of the same issue of the same publication.

(6) Advertisements in regional or national publications in an edition which is not by its contents geographically targeted to Indiana, but which is sold over the counter in Indiana or by subscription to Indiana residents.

(7) Advertisements broadcast on a radio or television station which are received by Indiana residents.

(8) Any other solicitation by telegraph, telephone, computer data base, cable, optic, microwave, or other communication system.

45 IAC 17-2-9 sets out a presumption, for FIT purposes, for when a business is deemed to regularly solicit business in Indiana:

A taxpayer is presumed, subject to rebuttal, to regularly solicit business within Indiana during a taxable year if at any time during the taxable year, the sum of the taxpayer's assets, including the assets arising from loan transactions, and the absolute value of the taxpayer's deposits attributable to Indiana, equal at least five million dollars ($5,000,000), *or if the taxpayer does any of the following during the taxable year:*

(1) Sells products or services of any kind or nature to twenty (20) or more Indiana customers who receive the product or service in Indiana.

(2) Solicits business from twenty (20) or more potential Indiana customers.

(3) Performs services outside Indiana that are consumed within Indiana by twenty (20) or more customers.

(4) Engages in transactions with twenty (20) or more Indiana customers that involve intangible property, including loans, but not property described in section 7 of this rule and result in receipts flowing to the corporation from such customers within Indiana.

However, if a taxpayer is presumed to be regularly soliciting business in Indiana, but its total activities in Indiana fall within the exempt activities identified in section 7 of this rule, the taxpayer is not subject to the FIT.

(*Emphasis added*).

IC § 6-5.5-4 deals with the attribution of financial institution receipts. Specifically, the statutory provision for attributing credit card receipts derived from customers both inside and outside Indiana is set out at IC § 6-5.5-4-8 which states as follows:

Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertaining credit card receivables and credit card holders' fees must be attributed to the state to which the card charges and fees are regularly billed.

As a preliminary matter, this Letter of Findings addresses Taxpayers' argument that neither Bank nor Credit have physical nexus with Indiana. Taxpayers argue they have no property, payroll, or sales in Indiana. Taxpayers state that PL 86-272 protects the limited activity of offering credit applications at the Parent's store; i.e., the mere solicitation of orders.

Public Law 86-272 (codified at 15 U.S.C. § 381) does not apply to the analysis of nexus in the context of Indiana's FIT. Public Law 86-272 prohibits a state from imposing a net income tax on an out-of-state entity that makes certain sales of tangible personal property in a state if the remote entity's business activities within the state consist only of soliciting orders of tangible personal property. The imposition of Indiana's FIT does not involve sales of tangible personal property. Therefore, the federal law does not apply.

Subsections (4) and (6) of IC § 6-5.5-3-1 - upon which the Department's assessment of FIT rests - are relevant and employ an "economic presence" test for determining whether a taxpayer is transacting business in Indiana such that the state can impose on the taxpayer the FIT.

The Department concluded that Bank had solicited business in Indiana. IC § 6-5.5-3-1(4). Pursuant to 45 IAC 17-2-8, a taxpayer is not required to be present within Indiana to be soliciting business. The Department argued that Bank solicited customers in Indiana, by, among other things, having Parent's employees - acting on Bank's behalf - offer at the point of sale financing and discounts or loyalty points if Bank's credit cards were used. Also, Bank solicited customers in Indiana when Parent – acting on Bank's behalf – placed credit applications throughout Parent's stores.

Taxpayers disagree with the application of 6-5.5-3-1(4) to Bank. Taxpayers argue that Bank does not actively solicit business in Indiana. At the hearing, Taxpayers stated that there is a "low-level" marketing relationship between Bank and Parent involving brochures, credit card applications, offers from store clerks to customers to sign up for the credit card and/or to accumulate "loyalty points" upon use of the cards, and in-store payment of the credit card accounts. Taxpayers stated that Bank makes the decision regarding offering and approval of credit.

Taxpayers are mistaken in describing the relationship between Parent and Bank as a "low level" marketing relationship or assuming that a "low level" marketing relationship somehow defeats the presumption that Bank is regularly soliciting business in Indiana. 45 IAC 17-2-9(2) presumes regular solicitation in Indiana when only twenty potential Indiana customers are solicited within the state. Furthermore, this "low level" marketing relationship that Bank exploits through its Parent is the lifeblood of Bank's proprietary credit card business. The overwhelming number of Bank's credit cards acquired by Indiana customers are acquired when Bank solicits their business at its Parent's retail location in Indiana. Taxpayer has not rebutted the conclusion. Taxpayer's argument that Bank, an Indiana remote entity, makes the decision regarding the offer and approval of credit, and not Parent, is irrelevant since the act of soliciting *potential* customers has already occurred prior to the offer and approval of credit. Tying Bank's solicitation activity to Parent's location in Indiana is not an attempt to attribute physical nexus of Bank to Indiana but rather to establish that Bank's regular solicitation of customers at Parent's Indiana retail location constitutes an exploitation of Indiana's financial markets, the activity at which the FIT is directed.

Bank argued that it made its money from merchant fees (both Parent's private label and a joint Parent-Visa card) and services fees from Credit or third parties (based on two-percent of average balance of receivables). However, what brings Bank under Indiana FIT, is its regular solicitation of business in Indiana, as discussed above. The fact that Bank then sells its receivables to Credit and makes its money in part by servicing the receivables has not been argued as determinative of Bank's liability for FIT in this instance.

Based on the above, Bank, a financial institution, clearly regularly solicits potential customers in Indiana.

The Department also concluded that Credit regularly engaged in transactions with customers in Indiana that involved intangible property, including loans, and resulted in receipts flowing to Credit from within Indiana through the payment of credit card receivables by persons in Indiana. IC § 6-5.5-3-1(6). The Department explained that persons located in Indiana made purchases on credit cards through Bank, and by this extension of credit, were given loans by Bank. These loans were then resold to Credit by Bank. Therefore the loans initially owned by Bank were then owned by Credit. The loans owned by Credit were established in Indiana, and the loans were repaid by persons in Indiana to Credit with Credit collecting receipts, including fees and finance charges, from Indiana residents.

Taxpayer disagrees with the application of IC § 6-5.5-3-1(6) to Credit. Taxpayer argues there are no transactions between Indiana customers and Credit. Taxpayer further argues that "the credit card payments are sent directly to a lock box outside Indiana." In other words, Taxpayer is saying Credit itself does not do business in Indiana.

Taxpayer is again mistaken. Credit card receipts, including interest income, merchant discounts, service charges, fees, etc., are attributed to the state to which the card charges and fees are regularly billed. IC § 6-5.5-4-8. When Bank performs the servicing functions on Credit's receivables, it is merely acting on Credit's behalf and is paid for those services. Furthermore, the fact that the credit card payments are sent directly to a lock box outside of Indiana is irrelevant since what is dispositive is not where the receivables are sent, but rather where they are regularly billed.

Taxpayers cite to IC § 6-5.5-3-8(5)(C) to argue that Credit's only activities in Indiana are in connection to owning an interest in a consumer loan not secured by real or tangible personal property and in which the payment obligations were solicited by someone independent and not acting on its behalf; i.e., by Bank.

IC 6-5.5-3-8 deals with events not considered transacting business in Indiana and states in relevant part:

> Notwithstanding any other provision of this chapter, a taxpayer,..., is not considered to be transacting business in Indiana if the only activities of the taxpayer in Indiana are or are in connection with any of the following:
>
> ...
>
> (5) Owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property.
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> ...
>
> (C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner....

However, IC § 6-5.5-3-8(5)(C) does not apply to Credit for two reasons. First, according to the operating agreement(s) referred to above, Credit pays Bank a fee to market and promote the retail card; thus Credit takes part in the solicitation of the loans. Secondly, even though Bank and Credit are separate entities, they are wholly owned subsidiaries of the same entity, Parent. Credit and Bank were structured by Parent to operate in tandem within its overall business structure.

Therefore, based on the above, Credit, a financial institution, clearly regularly does business in Indiana.

At the hearing, Taxpayers also argued that Tennessee financial institutions tax statutes are virtually the same as Indiana's, and that this case is "more like *J. C. Penney* than *Dillard's*." Taxpayers neither properly cited to their authority nor did they specifically state how *J. C. Penney* analysis supports Taxpayers' case or how *Dillard*'s is distinguished from it. Taxpayers offer further challenge to the FIT assessment on the ground that they do not have substantial nexus with Indiana. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Supreme Court stated that a tax will not be deemed to interfere with interstate commerce when the tax is "applied to an activity with a substantial nexus within the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Id*. at 279. Taxpayers' protest is based on the assertion that they do not have the minimum connection with the state necessary to establish the requisite "substantial nexus."

To the extent Taxpayers facially challenge the constitutionality of the FIT as applied to nonresident businesses having only an economic nexus with Indiana, the Department declines to address the question raised because the Department does not have the authority to determine questions of a constitutional dimension.

To the extent Taxpayers maintain that Indiana's FIT is – on its face – inapplicable, the Department must disagree. Under the statutes and regulations cited, Taxpayers fall squarely within the definition of non-resident entities conducting the business of financial institutions within this state; consequently, Taxpayers are liable for financial institutions tax as assessed by the Department.

FINDING

Taxpayers' protest is respectfully denied.

II. Tax Administration – Ten Percent Penalty.

DISCUSSION

Taxpayers protest the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Additionally 45 IAC 15-11-2(c) states:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and, thus, will be dealt with according to the particular facts and circumstances of each case. In this case, Taxpayers established that their failure to remit Indiana FIT was due to reasonable cause and not due to negligence.

FINDING

Taxpayers' protest is sustained.

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